

DR. DUDLEY: Okay. Thank you.

It's a pleasure to have the opportunity to testify before the Commission. I have three goals today.

First, I will try to convince you that the U.S. trade deficit is caused mainly by a shortfall of domestic savings relative to investment rather than unfair trade practice that limit our access to foreign markets.

Second, I will discuss what policy makers can do to reduce the dependence of the United States on foreign capital. The problem is not the reliance of the U.S. on foreign imports, but instead the fact that the current account deficit creates a financial claim on the United States that could under certain circumstances destabilize the U.S. dollar.

Third, I will argue that the U.S. trade gap may be overstated. Our dependence on foreign capital may not be as large as officially reported.

First, where do trade deficits come from? As I see it, chronic trade deficits are generally caused by an imbalance between domestic savings and investment rather than due to trade barriers and unfair competition. Consider that when investment spending exceeds the level of domestic savings, the consequence is upward pressure on interest rates.

That pressure raises the return on a country's fixed income assets. In other words, real interest rates rise. The currency appreciates as the expected return on the country's assets increases. This raises the price of exports in foreign currency terms, and thus reduces the exports' competitiveness.

As a result, imports grow faster than exports. The trade balance deteriorates, and the current account balance widens. The widening current account deficit is accompanied, by definition, with a growing inflow of foreign capital. This capital inflow, plugs the shortfall between domestic savings and investment.

This is a much more convincing story to me than the alternative. Foreign countries discriminate against U.S. goods and services exports. The result is a chronic U.S. trade deficit.

If foreign countries were to discriminate against U.S. goods and services, the result should not be a much larger trade deficit, but instead a weaker dollar. The dollar would weaken because the negative impact on exports would hurt economic growth. This would lead to lower interest rates, and the dollar would tend to weaken as a consequence.

This would improve U.S. trade competitiveness, raising exports and shrinking imports.

U.S. dollar would adjust in order to generate the required capital inflow needed to equilibrate savings and investment. The level of foreign trade barriers would influence where the dollar's value settled, but the trade balance would not be greatly affected.

To see the distinction between these two stories, consider what would happen if a country unilaterally lowered its trade barriers to the United States. The first round effect would be an increase in U.S. exports. This, however, would cause the U.S. economy to strengthen. U.S. interest rates would be higher as a consequence. The dollar would appreciate as U.S. financial assets became more attractive to foreign investors. Exports to other countries would decline as the strength of the dollar made exports elsewhere less competitive.

In the end, the trade imbalance would not be affected much. Instead, the proportion of exports to different countries would change, shifting towards those countries that did not lower their trade barriers.

So how does this fit in with recent U.S. history in which the U.S. trade deficit has soared? The dramatic widening in the U.S. trade deficit in recent years mainly reflects the fact that investment

spending in the United States has risen much faster than national savings.

This has necessitated large capital inflows to fill this gap. Required capital inflows have been generated in two ways. First, the dollar appreciates sharply during the 1996 to '98 period, especially against troubled emerging market economies as U.S. economic performance improved sharply relative to other countries.

Second, the U.S. grew much faster than its major trading partners. The result was that U.S. imports grew much faster than exports. This also helped widen the trade gap.

The important point to note here is that the dollar appreciated on a trade weighted basis even as the current account deficit widened sharply. This suggests that it was the ex ante imbalance between the foreign demand for and the support of dollar assets, demand outstrips supply, leading to a stronger dollar, that that's what helped to widen the current account deficit rather than trade barriers that existed abroad.

So what can be done? Having argued that the U.S. trade gap is mainly due to macro economic imbalances between domestic savings and investment, I would now like to consider what U.S. policy makers can do to address it.

First, measures that raise U.S. savings will tend to reduce the trade deficit and the dependence upon foreign capital over time. This could include running even larger fiscal surpluses or implementing government sponsored savings plans that encourage greater household savings.

Second, prudent economic policies that maintain the attractiveness of U.S. financial assets to foreign investors are important. The danger of a large current account deficit is that the foreign appetite for the country's assets could suddenly lessen. When this happens, the change in appetite registers first in the exchange rate.

Only over time does the trade and current account balance adjust. Thus, policy makers should want to avoid spooking foreign investors. A sudden attempt at flight on their part would lead to a collapse in the dollar, higher U.S. inflation, a deterioration in the U.S. terms of trade, and potentially a tighter monetary policy.

Although progress in getting foreign countries to reduce their barriers to U.S. trade will undoubtedly not have much of an impact on the aggregate trade balance, it is still a worthwhile goal for other reasons.

First, lower trade barriers abroad would tend to stimulate the demand for U.S. exports and lead to a stronger dollar, all else equal. A stronger dollar improves the terms of trade, raises the U.S. standard of living. Clearly this is a desirable outcome.

Second, lower trade barriers presumably increase the interdependence of the global economy. This has two benefits. It may reduce the prospects for armed conflict. It also tends to dampen the degree of volatility in economic activity.

As the U.S. economy has become much more open over the last few decades, the economy has become less cyclical. One can show that real GDP and the net export balance are negatively correlated. In other words, the trade sector helps absorb shocks to the U.S. economy and, therefore, makes the economy more stable.

The third question I'd like to address: is the trade deficit really as large as reported?

There are three facts to support the notion that the reported U.S. trade deficit may overstate the degree of the U.S. trade imbalance.

First, when one sums up all the current account balances around the world, one is left with a worldwide current account deficit of about \$150 billion. This indicates that there are significant

reporting errors somewhere in the world as the current account balances worldwide should, by definition, sum to zero.

Even more importantly, this gap has grown rapidly in recent years. This suggests a growing problem in measuring global exports.

Second, there's been a growing statistical discrepancy in recent years between the growth rates of real GDP measured by product, which includes export and import volumes, and the growth rate of real GDP measured by income, which has been considerably higher.

This suggests that the Department of Commerce statisticians are not counting all of the production or that income growth has been chronically overstated. If production is the problem, that may point to an understatement of exports.

Third, the national purchasing manager's report has shown a dramatic swing in trade performance with the export component now much higher than the import component. What this means is that a greater proportion of companies are seeing an increase in their exports compared to their imports.

Despite this, the U.S. trade balance continues to deteriorate. This is odd, given that in the past the national purchasing manager's readings on exports and imports usually did a good job

foreshadowing trade trends. Only recently has this relationship broken down.

Why might trade flows be misstated? We can think of two potential explanations. First, shifts in how goods and services are sold may mean that exports are not properly recorded. Internet transactions and the sale of software and other services may avoid the normal export accounting mechanisms leading to understatement of U.S. exports.

Second, U.S. multinationals may have understated the value of their exports to wholly owned foreign subsidiaries. This would be attractive as a means of reducing U.S. profits and avoiding U.S. corporate income taxes, especially when the companies were losing money on their overseas operations and did not have to pay corporate income taxes there.

This asymmetry between the profitability in the U.S. and elsewhere is a situation that has prevailed in recent years as growth in the U.S. has been strong and many other regions of the world have encountered difficulties.

The possibility that the U.S. trade deficit is overstated is an issue that may warrant further investigation by the Commission and others. This issue also suggests that greater resources may need to be

devoted to gathering information concerning the performance of the U.S. trade.

Thank you.

CHAIRMAN D'AMATO: Thank you very much, Mr. Dudley.

We'll move right on to Dr. Dugger.